Economic Trends

Low oil prices prolong downturn

This month's trends is taken from the Economic Outlook chapter of Budget 2016: The Alberta Jobs Plan, released on April 14, 2016.

Summary

The Alberta economy is experiencing a severe oil price shock. Oil prices have fallen more than 70% since June 2014, one of the largest declines on record. As a result, the downturn will be deeper and longer than previously expected (Chart 1). After contracting in 2015, real GDP is forecast to decline again in 2016 by 1.4%. Nominal GDP, a broad income measure, is forecast to fall by $57 billion between 2014 and 2016 and not return to pre-recession levels until 2019.

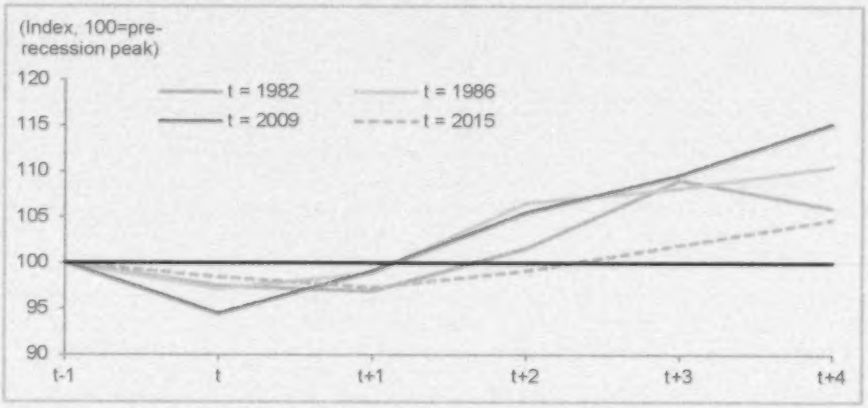
Business investment is expected to decline again this year. Weakness in the energy sector is feeding through the economy, causing activity to slow in many other sectors, including construction and manufacturing. As companies reduce costs, the labour market is expected to deteriorate further, leading to a decline in migration. Households are responding by cutting back on spending.

Despite the drag from lower oil prices, there are several factors that remain supportive of growth. Industries will benefit from weaker cost pressures and better labour availability. Alberta's population will continue to grow, albeit at a slower pace. Despite recent declines, average incomes are expected to remain well above the national average. Oil sands production will continue to expand in the near term, supporting exports. A solid US economy and weaker Canadian dollar will lift export-focused industries like agriculture, manufacturing and forestry.

Global Economy

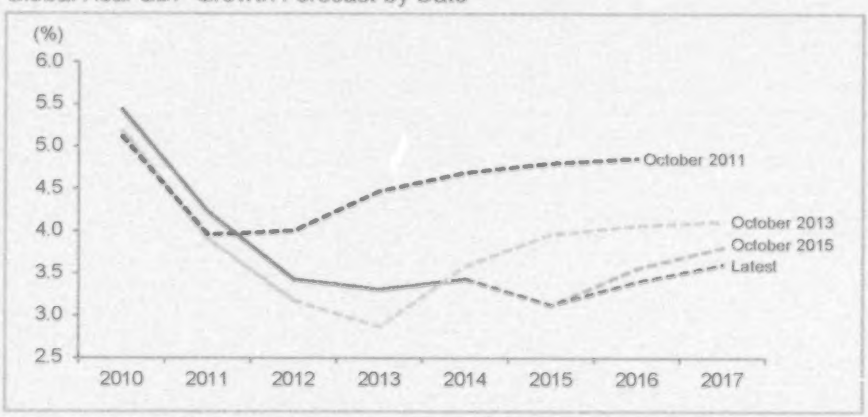
The impact of current low oil prices highlights the influence that external market conditions have on Alberta's trade and commodity driven economy. Though prospects for the global economy have moderated, growth is expected to improve after slipping in 2015 (Chart 2). Lower growth in China will continue to weigh on the recovery for commodity prices and contribute to volatility. Many central banks are expected to maintain accommodative monetary policy to bolster growth over the medium term. Overall, global GDP growth of 3.4% is expected in 2016, up from 2015.

Chart 1: A longer recovery for Alberta's economy
Downturns in Alberta Real GDP Since 1980



Source: Statistics Canada and Alberta Treasury Board and Finance

Chart 2: Global growth has repeatedly underperformed expectations
Global Real GDP Growth Forecast by Date



Sources: International Monetary Fund

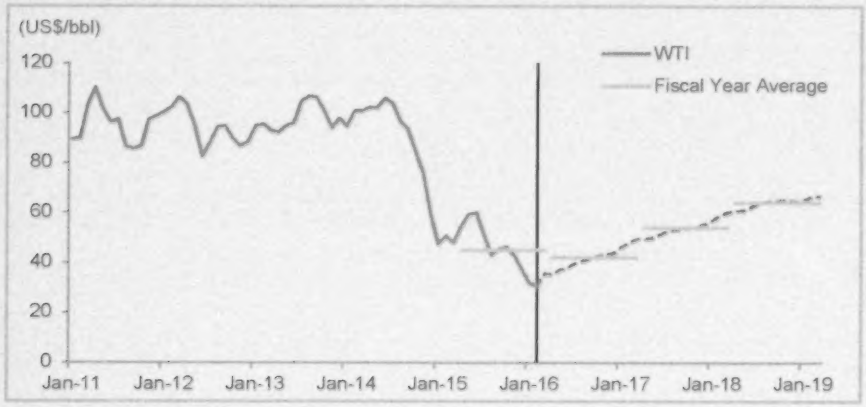
The US, Alberta's largest trading partner, continues to stand out among advanced economies. A markedly improved employment situation and robust domestic demand are expected to support forecasted growth of around 2.5% in 2016 and over the medium term. Employment growth, stronger business and consumer confidence, falling debt to income ratios and growing demand for housing will enable American consumers to keep the US economy on track.

Weaker outlook for global oil prices

In recent years, global oil production has outpaced demand, leading to an oversupply in the global oil market. This triggered an oil price correction in mid-2014 and pushed prices to the lowest level in over a decade at the beginning of 2016.

As a result of lower prices, oil investment worldwide fell in 2015, with weakness carrying into 2016. The decline in spending is expected to slow production growth this year, especially in the US. This will lead to a re-balancing of the market and gradually improving oil prices. WTI is expected to average US$42/bbl in 2016-17 and increase to around US$64/bbl by 2018-19 (Chart 3).

Chart 3: Oil prices are expected to improve as supply overhang clears
West Texas Intermediate



Source: Alberta Energy

Diverging economies among Canadian provinces

Canada's economy has been hobbled by low oil prices since the beginning of 2015, and real GDP is expected to grow only 1.4% in 2016. The slowdown has been primarily due to declining investment in the oil and gas sector. The collapse in commodity prices has changed growth prospects across the provinces, as more resource-intensive economies have slowed significantly. With the help of monetary and fiscal stimulus, growth is forecast to pick up to 2.3% in 2017 before slowing slightly over the medium term. Increased access to international and coastal markets remains important to investment in the Canadian energy sector and economic growth.

Since mid-2014, the Canadian dollar has been under pressure from lower oil prices, weaker growth prospects and interest rate cuts by the Bank of Canada. Recent strength, mainly related to a depreciating US dollar, is not expected to be sustained. The dollar is forecast to gradually appreciate to US¢77.5/Cdn$ by 2018-19, consistent with a slow improvement in oil prices.

Alberta Economy

The recession in 2015 was caused by lower energy investment. In 2016, the effects will be more broadly felt. Momentum that supported activity in the province has faded, prompting a pullback in construction and spending. Alberta's labour market has been hit hard, and unemployment is expected to remain elevated into 2017. A gradual improvement in oil prices will support economic growth over the medium term. Exports, led by expanding oil sands production, will continue to be the main growth driver. Other sectors will benefit from improved labour availability and reduced costs, along with a weaker dollar and strengthening US economy.

Corporate profits hit by low prices

The continued slump in energy prices has hurt producers' cash flow and squeezed corporate profits. Oil and gas companies and their suppliers have been most directly impacted, but other companies' profits have also suffered from weaker activity in the province. Net corporate operating surplus, a measure of corporate profits, is expected to decline around 18% in 2016, after falling over 50% in 2015. The moderating outlook for oil prices and economic activity mean that corporate profits are not expected to return to pre-recession levels over the forecast period.

The price that Alberta producers receive for their crude has fallen sharply with the decline in WTI prices. The Alberta heavy oil benchmark WCS price fell below US$20/bbl in January 2016 to the lowest level since trading began in 2004. The light-heavy differential has remained fairly steady, and is expected to average US$15.20/bbl in 2016-17. Over the next few years, however, oil sands production is expected to rise faster than available pipeline capacity, increasing reliance on rail. This will cause the differential to widen to US$18.50/bbl by 2018-19 and reduce the profitability of projects, especially given the low price environment.

Lower oil production in the US is expected to cause a decline in associated gas; however, continued strong growth in US shale gas production and increased cost efficiencies will maintain downward pressure on natural gas prices in North America. The Alberta Reference Price is expected to average Cdn$2.40/GJ in 2016-17 and rise to just Cdn$3.00/GJ by the end of the forecast period.

Slow recovery in oil and gas investment

Energy producers have responded to low prices by cutting capital spending. Oil and gas investment is expected to contract by over 20% in 2016 after declining almost 37% in 2015. Companies are expected to be cautious about spending, and some consolidation within the industry is likely as firms with healthy balance sheets acquire those under financial stress.

The short life cycle of conventional investment makes it more sensitive to the near-term price outlook. The renewed decline in oil prices at the end of 2015 dragged down drilling activity further in the winter months, a period when drilling normally picks up.

With natural gas prices remaining depressed, natural gas drillers continue to target natural gas liquids (NGLs), whose prices are tied more closely to oil. Demand for condensate, which is used to dilute bitumen for transport, remains strong in the province. Drilling levels are at historic lows, but natural gas drilling technology continues to improve, which means that production is expected to decline only moderately over the forecast period.

Overall, conventional investment is forecast to contract by 16% in 2016, after a pullback of over 50% in 2015. As prices improve in 2017, conventional investment is expected to begin recovering but will remain well below 2014 levels.

The decline in oil sands investment has been much less pronounced compared with conventional because oil sands projects have long life cycles and those under construction already have large amounts of committed capital. With the outlook for oil prices moderating, however, oil sands investment is expected to continue slowing over the next three years. Spending will be focused on the maintenance of existing facilities and the completion of projects that were under construction prior to the price decline.

Energy weakness spreads

Non-residential building construction slumped for most of 2015, despite a large increase in institution and government construction spending. After a solid first quarter, industrial and commercial building construction started to fall and the pace of the declines accelerated through the end of the year. Weakness is expected to continue in the near term, reflecting lower activity in the province and the winding down of current projects. Strong population growth in recent years has increased the need for public infrastructure, and plans by the government to bolster capital spending during the downturn will partially offset the decline in private construction in the next three years. Despite this lift, non-residential investment is expected to fall in 2016 and 2017 before picking up.

Energy-related manufacturing saw broad-based declines in 2015. Petroleum and chemical sales fell on lower prices. In addition, the downturn in drilling across North America and lacklustre performance of America's industrial sector dampened demand for Alberta-made industrial machinery and equipment. Real manufacturing shipments declined over 8% in 2015 and are forecast to decline again in 2016. Starting in 2017, however, manufacturing activity is expected to increase, which will support exports, as refinery capacity expands, plastics manufacturing benefits from increased investment and the Petroleum Diversification Program and lower feedstock costs encourage development of petrochemical facilities.

Slowing economy hits Alberta labour market

The plunge in oil prices and accompanying decline in investment and activity in the province have weakened Alberta's labour market. Annual employment is forecast to decline 1.7% after remaining fairly resilient for most of 2015. Though employment should start to recover in 2017, growth is expected to be less than 1%. Overall employment is not forecast to return to 2015 levels until 2018.

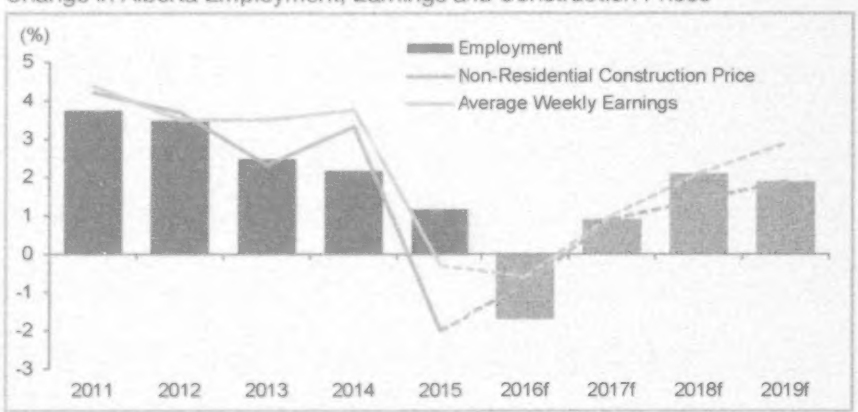
Efforts by businesses to trim labour costs have weighed on earnings. Alberta average weekly earnings declined by 0.3% in 2015, the first annual decline in 20 years. While service sector earnings remained resilient, overall earnings were pulled down from disproportionately large job losses in higher-paying goods sector industries. This weakness is expected to persist in 2016, with average weekly earnings forecast to fall an additional 0.6%. Earnings are expected to improve gradually starting in 2017. With lower earnings and employment, labour income is expected to fall in 2016, taking primary household income with it, before recovering in 2017.

Cost pressures easing

With economic activity slowing, cost pressures will continue to ease in 2016 (Chart 4). In addition to reducing labour costs, companies are seeking out price reductions

Chart 4: Firms are cutting labour costs

Change in Alberta Employment, Earnings and Construction Prices



Sources: Statistics Canada and Alberta Treasury Board and Finance, f-forecast

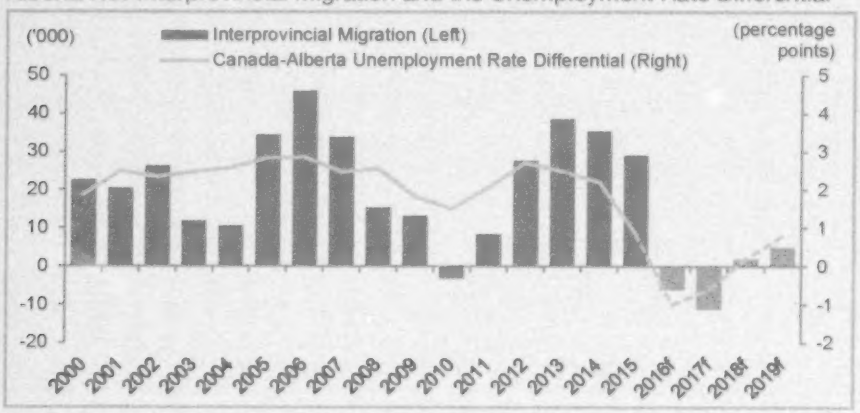
from suppliers and implementing in-house cost efficiency measures, both within and outside of the energy sector. Construction costs are also coming down.

Lower energy prices and weaker economic activity have also kept inflation contained. They have partially offset the impact of the lower Canadian dollar, which has lifted the prices of food, appliances and other imported goods. As energy prices improve and prices remain elevated for imported goods, inflation is expected to rise to 1.5% in 2016 and average about 2% over the remainder of the forecast period.

Population growth moderates

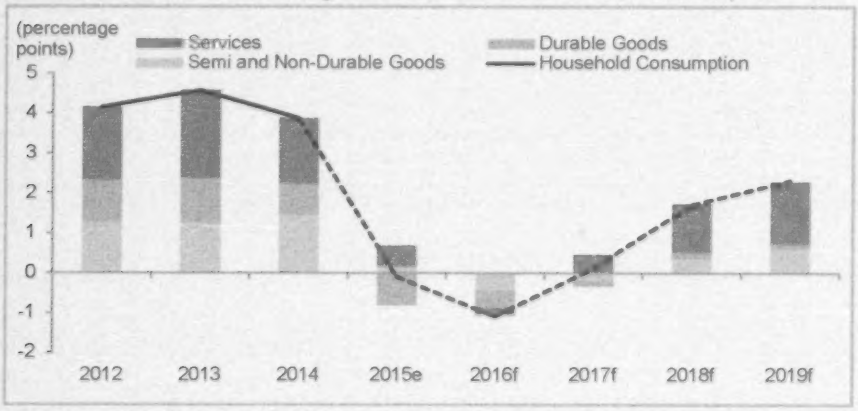
The pace of Alberta's population growth will slow as migration weakens over the next two years. Population growth is forecast to moderate to 1.2% in 2016 and 1.0% in 2017. Alberta is expected to see a net outflow of 17,000 interprovincial migrants over 2016 and 2017 due to weaker labour conditions (Chart 5). Net outflows of non-permanent residents will also weigh on population growth over the next few years, mainly because of changes to the federal Temporary Foreign Worker Program (TFWP). The arrival of large numbers of immigrants is forecast to keep overall migration positive, while natural increase will continue to provide a solid base for population expansion due to Alberta's young population. As migration picks up, population growth is forecast to increase to 1.4% by 2019.

Chart 5: People are seeking job opportunities in other provinces
Alberta Net-Interprovincial Migration and the Unemployment Rate Differential



Sources: Statistics Canada and Alberta Treasury Board and Finance, f-forecast

Chart 6: Consumers reduce spending on goods
Contribution to Percent Change in Alberta Real Household Consumption



Sources: Statistics Canada and Alberta Treasury Board and Finance, e-estimate, f-forecast:

Unemployment rate to decline gradually

Despite deteriorating economic conditions and declining employment, Alberta's labour force has continued to expand. This has resulted in an increasing unemployment rate, which surpassed the national rate for the first time since 1988 and reached a 20-year high of 7.9% early this year. The unemployment rate is expected to remain elevated over the next two years, averaging 8.0% in 2016 and 7.5% in 2017.

A combination of gradual employment growth and people leaving the labour market is expected to facilitate a steady decline in the unemployment rate to 5.8% by 2019.

Households pull back on Spending

Falling incomes and uncertainty about the economy are leading consumers to pull back on spending (Chart 6). Retail sales declined almost 4% in 2015, with a large drop from durable goods, especially motor vehicles. Adjusted for inflation, consumer spending is forecast to decline over 1% in 2016 after falling slightly in 2015. Slowing population growth will be a drag on spending in the next two years; however, Alberta's high per capita income, improving labour market and relatively low interest rates will support an improvement over the medium term. Real consumer spending is not expected to surpass 2014 levels until 2018.

With declining incomes and moderating population growth, housing starts are forecast to fall to 22,200 in 2016 and 19,400 in 2017. Beyond 2017, an improvement in the labour market and population growth will lead to a gradual recovery in housing starts.

Solid prospects in other sectors

Although the effects of oil prices on the economy have been far-reaching, there are some sectors that continue to show strength.

In the agriculture sector, Alberta's agri-food exports increased 3% in 2015, reaching a record $10 billion. Much of the increase came from value-added food manufacturing sales, a bright spot in Alberta's manufacturing sector. Prospects for the agriculture sector remain encouraging beyond 2016.

The forestry sector is also expected to benefit from stronger production. Forestry product exports increased over 4% in 2015, supported by a significant increase in lumber shipments. The forestry product sector is expected to continue expanding, aided by a weaker Canadian dollar, solid US housing activity and steady demand from Asia.

The tourism sector is another sector benefiting from the weaker Canadian dollar and a strong US economy, which are boosting the appeal of vacationing in Alberta and encouraging Albertans to travel closer to home. There has been a drop off in business travel, however, with the pullback in economic activity in the province. Business travel is expected to remain weak in 2016. Occupancy rates will pick up as overall economic activity increases.

Growing oil production lifts exports

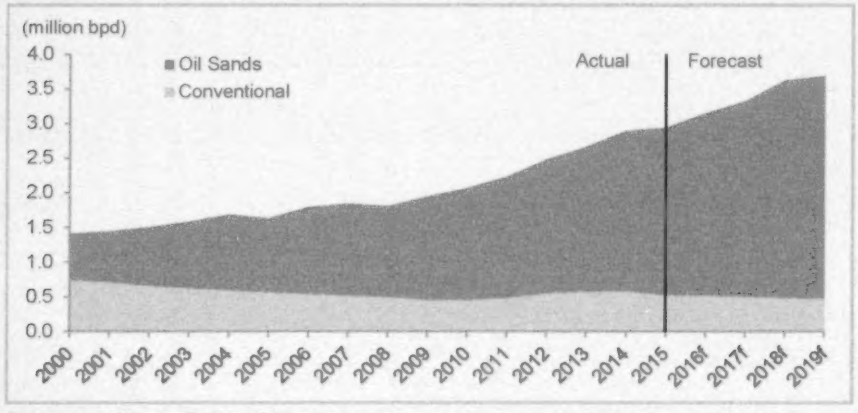
Oil production will continue to rise, despite lower prices (Chart 7). After several years of large-scale investment, a ramp up of new oil sands projects led to strong growth in crude production in 2015. Gains will continue as more projects shift from construction to production. Conventional oil production will continue to decline, but at 20% of Alberta's total oil production, it will have a small impact on overall production.

Given the production profile of the oil sands and other sectors, there is a continuing need to build and expand the transportation infrastructure. Pipelines lower transportation costs relative to rail by about US$6-8/bbl. Additional pipeline capacity from Alberta would also improve access to international and coastal markets.

Trade gains support growth

Exports are providing a needed boost to the economy. Although lower oil prices drag down the value of crude exports, export volumes continue to expand with oil sands production. Exports from other industries including agriculture, forestry, food manufacturing and services are also expected to partially offset the declines in energy-related manufacturing this year. As the Alberta economy adjusts to lower oil prices and activity picks up, exports are expected to add around two percentage points to annual real growth over the next four years. Overall, export-oriented industries will benefit from easing cost pressures, the lower Canadian dollar and a solid US economy. Rising exports and declining imports are cushioning the impact of declining investment and spending on Alberta's real GDP this year.

Chart 7: Oil sands production to grow despite drop in prices
Alberta Oil Production



Source: Alberta Energy, f-forecast

Risks to Economic Outlook

- Oil prices are forecast to improve gradually. A further drop in oil prices could arise from weakening global demand or a slow supply response to low prices. Should low prices persist or fall further, Alberta's outlook would weaken.
- Without improved market access, Alberta oil producers could see the return of large and volatile price discounts. A higher-than-expected reliance on rail will weigh on revenue and investment, and could impact other sectors that also rely on this mode of transport.
- Emerging economies remain vulnerable to financial market shocks, as concerns remain about financial stability and overall growth prospects. A further slowdown in these markets would weigh on commodity prices, hurting Alberta's growth prospects.
- Increased uncertainty about the economy could further erode consumer and business confidence, reducing spending.
- On the upside, an improvement in oil prices would improve Alberta's growth prospects. This could come from stronger global economic growth, supply outages or a move by OPEC to reduce supply and support prices.

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